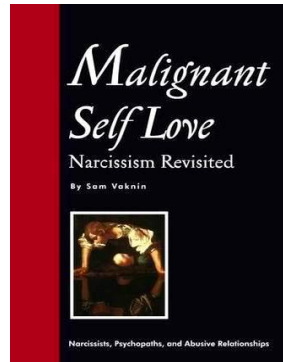


The Cost of Unification German Lessons for Korea

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By late 2010, a succession war was simmering in North Korea. His panoply of suddenly-bestowed senior political and military posts notwithstanding, the generals and military establishment were less than happy and impressed with Kim Jong-un, the younger son of the Dear Leader, Kim Jong-il. Each side flexed muscles in an attempt to burnish their nationalist and martial credentials. The outcomes of this internecine conflict were ominous: a series of ever-escalating military skirmishes with South Korea and the ramping up of North Korea's already burgeoning nuclear weapons program.

The regime in North Korea is all but dead on its feet. These are its last days. China is facing the terrifying spectacle of a crony failed state with tens of millions of starved and destitute potential refugees swarming across its porous and indefensible borders. There is only one solution to all the problems of the Korean Peninsula: unification. The parties came close to discussing it in secret talks in 2002 and then again in 2009.

In July-August 2002, the north and south rumps of an erstwhile unified Korea have agreed to reconvene, at North Korea's rare request, cabinet-level talks severed the year before. Only 6 weeks before that, on June 29, 2002 vessels of these two countries clashed to lethal effect in the Yellow Sea: an incident for which the North now, startlingly, expressed its regrets.

The South's indefatigable unification ministry concluded the three-days negotiations on August 14, a day before both polities celebrate the end of the brutal Japanese occupation. North Korea also consented to participate in the 14th Asian Games, held in September 2002 in Busan in South Korea. It even partook in a friendly football match with the South.

Noble prizewinner South Korean president at the time, Kim Dae Jung launched his "sunshine policy" - a Korean Ostpolitik - towards the famished and decrepit North in June 2000, when he met the "Dear Leader", Kim Jon Il. This led to precious little hitherto. A few members of families divided by the war in 1950-3 were finally allowed to briefly reunite. North Korea gorged on South Korean and Japanese grain and extorted cash from visitors to the much adored Mount Geumgang.

UPI was among the first to report a discernible shift to market principles in the North. This was coupled with thawing relations with the West, notably the United States. Both the Japanese foreign minister and America's secretary of state conversed with their North Korean counterpart during the ASEAN regional forum in Brunei in early August 2002. The North even requested talks with the US-led United Command it so decries.

These breakthroughs were followed by frequently interrupted rounds of negotiations between the United States and North Korea, in the presence of 4 observer nations (among them Russia and China). North Korea admitted, in the process, to owning nuclear weapons and extorted additional economic benefits from its southern neighbor. The United States demands unilateral and unconditional nuclear disarmament and accuses the North Korean "tyranny" of illegal proliferation of nuclear materiel and technology.

But, otherwise, the North remains as recalcitrant and belligerent as ever. The prospects of Korean unification are best gauged in Panmunjom, scene of the armistice that ended the Korean war, where a South Korean rail line ends abruptly.

The North has yet to construct the few miles to Kaesong within its territory. North Korea's Committee for the Peaceful Reunification of the Fatherland continues its vitriolic diatribes against South and West alike.

Unification is not a straightforward matter not only geopolitically or politically - but also, and, perhaps, mainly, economically.

In a Northeast Asia Peace and Security Network Special Report dated August 1999 and titled "Modeling Korean Unification", the authors, among them Marcus Noland, a leading authority on the subject, recommended a customs union between the two Koreas as a way to ameliorate northern famine and generate a peace dividend through military demobilization.

The authors believe that unification will affect South Korea's "composition of output, the distribution of income, and the rate of economic growth". Should capital flow in from the rest of the world, the won is likely to appreciate and the "nontraded goods sectors could expand at the expense of the traded goods sectors".

It would take at least a decade for northern incomes to reach 55 percent of southern ones.

"The amount of capital investment necessary to raise Northern per capita incomes to 60 percent those of the South would actually drive the rate of return on capital in the North below that in the South. However, it would be possible to attain the 60 percent target without such equalization of the rate of return in the two parts of Korea under high-end estimates of the speed of technological convergence. This suggests that either the rate of technological convergence would have to be very rapid (say, 12 percent annually), or restriction on migration from the North to the South would have to be imposed on a semi-permanent basis."

South Korea itself is likely to be as transformed by unification as the north. Cheap migrant labour from the across the erstwhile border will tilt the balance between income from capital and income from labor in favor of the former. As northerners occupy low-skill jobs, southerners are bound to monopolize the high end of the labor market. Income inequality will widen.

Noland believes that the cost of unification can be limited. It is hard to see how, though. Inter-Korean trade leapt 21 percent year-over-year to a meager \$130 million in the first four months of 2002 - including \$51 million in "non-trade" items, such a food grants.

The North maintained a trade surplus of \$51 million with the South in these 120 days, excluding humanitarian assistance and Southern gifts. It exported to the South agricultural products, fish, and textiles and imported from it machinery, chemicals, and processed textiles. A mere 62 companies - of a total of 188 -

worked on a "processing-on-commission" basis, elsewhere a very common practice in least developed countries.

The World Bank sounds more realistic when it pegs the overall cost at 5-6 times South Korea's GDP, or \$2-3 trillion. Noland notes that between \$300-600 billion over ten years would be needed to raise North Korean income levels to 60 percent of the Southern average and to prevent ruinous mass migration from North to South. Young-sun Lee, another scholar, concurs with the high end of Noland's estimate.

The historical irony is that the North, until 1950, has been the industrial powerhouse of the united Korea. Mining, heavy industry, and science were all concentrated in the north. The south was home to agriculture and light, family-owned, industry. Despite American carpet bombing which pulverized its manufacturing base, the North grew faster than the south throughout the 1950's and 1960's - albeit partly thanks to Chinese and Russian monetary infusions.

But while the south - with double the north's population - leapt from an average GDP per capita of \$90 in the mid-60's to almost \$9000 in 1999 - the north crept to one tenth, some say one twentieth, this figure in 2001. And while North Korea's foreign trade is a measly \$2 billion - the South trades almost \$300 billion in goods and services. After China and Japan, South Korea is the North's largest trading partner.

The harrowing stories of fatal famine in the North are a commonplace by now. Even by its official - and, thus, false - figures, the North admits to a quarter of a million deaths by starvation. The figure may be 10 times as high. Energy shortages mean that factories are working at 10-15 percent capacity, reported "The Economist" in August 2002.

Though far more suave, the South may be pursuing a passive-aggressive tack of its own. Unification is likely to be a better avoided prohibitively expensive and economically destabilizing affair. An apt parallel would be with Yemen, whose Marxist and destitute south united with the far more prosperous and open north only to yield a devastating civil war two years later. But the Koreans optimistically prefer to compare their situation to pre-unification Germany.

A decade and \$1 trillion in subsidies later, not counting \$2.6 billion in annual handouts from the European Union - east Germany is still woefully trailing its west. According to figures published by The Frankfurter Allgemeine Zeitung, the growth rate and productivity of the east - the German mezzogiorno - is a mere 70 percent of the western Lander. The east contributes one tenth of German GDP with one fifth of the population. A quarter of a million jobs have evaporated between 1998 and 2002 alone.

Unemployment, at 17.8 percent in June, 2002 is the highest since 1990. The tax base is shrinking as the dreary region is drained of its populace. Three years ago, Germany has extended federal aid to the east - financed by a much-resented 5 percent surtax - by another 20 years.

This massive failure is a hot topic in every election campaign in Germany. BMW has been courted, cajoled, and bribed with copious tax breaks to open a new factory in Leipzig. Volkswagen's decision to launch a positively minor plant in Dresden was hailed as a breakthrough.

On a visit to Seoul in 2002, German Nobel laureate Gunter Grass cautiously suggested that unification may follow a long period of engagement. He hoped, he said, that Korea will not repeat the mistakes that his country committed - the exorbitant taxes and the human dislocation. He bemoaned the lack of cultural and artistic exchanges between the Koreans.

But Korean unification may pose more than belletristic predicaments.

Another German, Otto Graf Lambsdorff, compared the Korean experience to the German one in a guest column in the "Korea Herald":

"The (economic) conditions in Korea ... (are) more difficult than those in Germany around the time of its reunification ... In relation to the West German population, the East German population was much smaller than the respective proportions of North to South Koreans ... The discrepancy regarding the level of economic development is much larger between South and North Korea than it was between West and East Germany ... It is sometimes overlooked that in the case of East Germany about one-third of the economic production was delivered by a private and cooperative sector ... Furthermore, in contrast to the ... isolation (of North Korea), (East Germany) participated actively and with a certain degree of success in international economic exchanges."

He noted that it took Germany 20 years to unite after the first east-west summit in 1970. But the parallels end there. By being absorbed in West Germany, the east gained immediate access to the European Union. There is no Asian equivalent of a common market. Moreover, the North Korean market is geared to support a bloated military and to produce weapons, especially missiles. Demobilization may prove to be a thorny issue economically as well as politically.

In Korea's case the very term "unification" may be misleading. According to a "Korea Times" commentary by Dr. Park Eung-kyuk of Hanyang University, the South aims at an EU-like confederation while the North counters with a loose federation.

Is there anything these two disparate polities can learn from the German experience?

The first serious effort to answer this question was made in 1993 by an expert group chaired by former German chancellor, Helmut Schmidt. Its conclusions and policy recommendations reverberate through subsequent scholarship and commentary. In July 2002, the *Frankfurter Allgemeine Zeitung*, neatly summed up the error-ridden unification process thus:

"At unification, many western companies viewed the East as a new export market, a consumer land. Instead of investing in production sites there, they funneled goods and services to a consumption-starved public armed with a cash windfall from the currency exchange."

The Kohl-mandated exchange rate of 1 ostmark to 1 deutschmark rather than the previous and more realistic rate of 4:1 had grave repercussions. To avoid inflation, the Bundesbank was forced to raise interest rates and induce a recession.

The paper continues:

"Eastern goods were priced out of the market as manufacturing cost quadrupled overnight. The country's chief export market, the former Soviet bloc, also went bankrupt. Local consumers bought western goods. No revenue flowed back to the East, touching off a mass exodus of labor that reduced the workforce by one-third in three years."

In a book titled "Avoiding the Apocalypse" and published in 2001 by the Institute for International Economics, Marcus Noland disputes this scenario. The culprit was wage policy, not the exchange rate. On the contrary, the transfer of wealth to the east through the exchange rate mechanism eased its problem of lack of competitiveness and did not result in inflation. He even goes as far as floating an idea of dollarizing inter-Korean trade.

Driving east German wages beyond productivity - in response to labor union pressure - depressed output and may have encouraged westward migration. The sluggish rate of privatization served to perpetuate mismanagement. The practice of property restitution impeded the assignment of clear property rights and, as a result, hampered investment. Privatization was further hobbled by the refusal to write off enterprise debt outright.

The Schmidt commission strongly differs:

"In transferring to a market economy, it is not possible to leave everything to market forces. The deficiencies of the infrastructure in the former GDR were grossly underestimated as was the environmental contamination, the lack of

modern technology. The political, legal, economic, educational, and social security systems changed, including traffic rules. It is an enormous achievement for the East German population to have coped with the stress created by this veritable revolution. But it also created distrust, lack of initiative, confusion, and fear all of which should have been more effectively addressed."

The recipe which seems to enjoy a consensus among scholars and politicians alike calls for a gradual unification. Trading and investments should be followed by a currency union at a realistic exchange rate, land reform in the North, and the institution and restitution of property rights. Tourism and services establishments should be privatized first, agriculture later.

The state would have to design and implement a series of industrial policies to prevent market failures and provide public goods. Its top priorities should be infrastructure and institution building. Human capital must be augmented by the transfer of qualified personnel from the south while northerners are trained or retrained. It may be necessary to restrict immigration during a transition period.

Help and support from the international community - Korea's neighbours, the Asian Development Bank, the IMF, the World Bank, the West - would be indispensable. It is here that unification may blunder.

Many Asian countries - not least, China - may be unhappy with the idea of a united, independent, and economically prosperous Korea under Western influence. Lending to emerging economies - not to mention unification projects - has dried up and is likely to remain so for years to come. The West has its own agenda regarding the "axis of evil". Ultimately, Koreans trying to unite may be faced with an insurmountable common adversary - geopolitics.

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